COMPLIANCE INFORMER ®

***Provided by Hardin Compliance Consulting LLC***
***December 17, 2018***

# The Real Nightmare Before Christmas: SEC Gets Tough on Firms that Did Not Self-Report during SCSD Initiative

*By: Jaqueline M. Hummel,*
*Partner and Managing Director*

The SEC's Enforcement Division is following up on the Share Class Selection Disclosure Initiative (the "SCSD Initiative") by sending out document requests to dually-registered investment advisers and investment advisers with broker-dealer affiliates that did not self-report. (See our April 2018 blog post for more details on the initiative.) The focus of this sweep is 12b-1 fees and revenue sharing and requires advisers to review their records going back to 2013. (See our March 2018 blog post on the terms of the SCSD Initiative.)

Similar to the questionnaire from SCSD Initiative, the Enforcement Division is asking for disclosure about the aggregate amount of 12b-1 fees received by firms and their affiliates and the amount of 12b-1 fees charged to clients over the past five years. The division may also ask firms to perform an analysis of all available share classes of the mutual funds purchased for client accounts to determine the amount of 12b-1 fees (if any) that the adviser's clients would have incurred if they had been invested in the lowest-cost share class available. This analysis can be a nightmare of data-gathering for firms, depending on the number of mutual funds used in client accounts. Firms will need to determine:

- which share classes were available during the relevant period from the fund company
- whether their clients were eligible for lower cost share classes of the same fund
- whether lower cost share classes were available on their clearing firms' platform during the relevant period

This data is also required for money market sweeps used.

In addition to 12b-1 fees, the Enforcement Division is asking for disclosure of any revenue-sharing agreements and payments received by dually-registered investment advisers and investment advisers with broker-dealer affiliates. Revenue sharing arrangements were not part of the SCSD Initiative.

Firms may also be asked to disclose all policies, procedures and guidelines regarding mutual fund share class selection for the past five years. The Enforcement Division also wants to see any internal documents and communications discussing the SCSD Initiative. Based on these requests, the SEC is

delving into firms' decision not to self-report, most likely as a means to justify imposing greater penalties.

Finally, the SEC may also request that firms enter into a tolling agreement, which suspends the statute of limitations for an agreed period, in exchange for an extension of the deadline to gather the requested data. This allows the SEC to preserve its ability to pursue charges going back 2013 during its investigation.

*Steps to Take Now for Firms that Did Not Self-Report*:

1. Review the SDSC Materials. If your firm is a dual registrant or has an affiliated broker-dealer and you are receiving 12b-1 fees or revenue sharing payments, review the SEC's announcement on the Share Class Selection Disclosure Initiative, the accompanying questionnaire and the FAQs. Chances are, you will be receiving a letter from the SEC's Enforcement Division asking for the same information outlined in the questionnaire. Seriously consider whether to stop receiving such payments in the future.
2. Review the disclosures in Form ADV, your advisory contracts with clients and consider whether to revise these disclosures. The SEC has been adamant that the receipt of 12b-1 fees and revenue sharing payments are conflicts of interest that require explicit disclosure. An adviser that receives 12b-1 fees (whether directly as a dually registered broker-dealer or indirectly through an affiliated broker-dealer) as a result of using mutual fund share classes with 12b-1 fees for its clients should specifically state on its Form ADV Part 2A that:
    - The firm [or its affiliate(s)] receives [insert type of payments, such as 12b-1 fees, revenue sharing payments, marketing support payments, etc.] from [insert relevant source of payment];
    - These payments present a conflict of interest between the firm and its clients' best interests. Simply put, the firm has a financial incentive to invest client assets in mutual funds where the firm or its affiliate(s) receive [insert relevant reference, i.e., revenue sharing payments, 12b-1 fees, marketing support payments, etc.]; and
    - The firm and its IARs select mutual fund share classes that charge 12b-1 fees, even in situations where clients may be eligible for lower cost share classes of the same fund.
3. Start gathering the data needed to perform the share class analysis. Many clearing firms already gathered some of this data for firms to assist them in making the decision whether to self-report. See the questionnaire for the data requested.
4. Review your policies and procedures related to share class selection. The SEC's announcement of the SCSD Initiative specifically references three 2017 enforcement actions. Advisers should check out these cases for insights regarding what the SEC considers to be adequate mutual fund share class selection disclosures and related policies and procedures: In the Matter of SunTrust Investment Services, Inc. (STIS); In the Matter of Cadaret, Grant & Co *and* In the Matter of Credit Suisse Securities (USA) LLC.

---

**Partner with Hardin Compliance**

Keeping up with the latest SEC mandates can be daunting; partnering with Hardin Compliance can bring you peace of mind with our comprehensive compliance services. Call us today at 1.724.935.6770, or visit our website at www.hardincompliance.com for more information.

---

*Hardin Compliance Consulting provides links to other publicly-available legal and compliance websites for your convenience. These links have been selected because we believe they provide valuable information and guidance. The information in this e-newsletter is for general guidance only. It does not constitute the provision of legal advice, tax advice, accounting services, or professional consulting of any kind.*